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Chairman, Securities Industry Association
Before the House Financial Services Committee
Subcommittee on Domestic and International Monetary Policy
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Testimony of Richard E. Thornburgh, Chairman, Securities Industry Association Before the House Financial Services Committee Subcommittee on Domestic and International Monetary Policy June 17, 2004

Madam Chair and members of the Subcommittee: I am Richard E. Thornburgh, the 2004 Chairman of the Securities Industry Association[1], as well as the Chief Risk Officer for Credit Suisse Group, a member of the Executive Board, and ex-officio member of the Credit Suisse First Boston Operating Committee.

Thank you for your continued interest in the U.S.-EU Financial Markets Dialogue, and the European Union's Financial Services Action Plan (the "Action Plan" or the "FSAP"). I also thank you for giving me, and the Securities Industry Association, the opportunity to be heard on these topics, which are of great interest to financial market participants in the United States and Europe.

My testimony today will focus on the critical importance of U.S. involvement in the development of EU capital markets. In particular, I will make the following points:

1) The U.S.-EU Financial Markets Regulatory Dialogue is working – we need to build on what is now in place;

2) The EU capital markets are both a critical source of investment capital for U.S. companies, and vital to U.S. investors, asset managers, and pension and mutual funds seeking portfolio diversification;

3) Proper implementation of the "Action Plan" or "FSAP" is essential for the creation of an integrated, transparent, and liquid capital market; and

4) We recommend a U.S. Action Plan to complement the implementation of FSAP including:

    a. Placement of a Treasury Attaché in Brussels;

    b. Increased inter-agency coordination – particularly utilizing State Department contacts in EU member states;

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

c. Formalized regulatory dialogue between the SEC and the Committee of European Securities Regulators (CESR) on regulatory convergence, as has been started; and

d. Greater Congressional/Parliamentary interaction.

The Dialogue is Working

I am especially pleased to testify today about the U.S.-EU Financial Markets Regulatory Dialogue. The securities industry believes that this Dialogue can be a starting point as well as an integral tool in promoting the best interests of the U.S. and EU economies and capital markets, including the development of an equity culture.[2] With the Dialogue in place, we believe it should be complemented with a coordinated U.S. inter-agency Action Plan (USAP) that can work with individual EU members states and Brussels to achieve FSAP goals: an integrated, deep, transparent and liquid European capital market.

The securities industry – both here and in the EU – has been a strong supporter of the FSAP. We have worked closely with the European Commission, the European Parliament and member-state regulators to help ensure that the Action Plan's objectives for a single, integrated, efficient EU capital market is realized. The FSAP is a considerable undertaking and we commend the continued commitment of member-state governments, the European Parliament, and the European Commission to this endeavor. I will discuss the FSAP's initial successes, which we believe are substantial, and certain aspects of the Action Plan, such as the Investment Services Directive (ISD), that we believe might have been accomplished differently if the Dialogue had been in place earlier.

Perhaps most importantly, I will address the future, and the desirability of building on existing capital-market linkages through a U.S.-EU regulatory-convergence dialogue. Not only are these issues important for the continued growth and integration of the EU's capital market and the broader transatlantic capital market, but also they are issues we believe will benefit greatly from the collective views to be offered by the participants to the U.S.-EU Financial Markets Dialogue. In this regard, we commend both the U.S. and EU for their consultation with SIA on capital-markets issues related to the Dialogue.

The FSAP (And The Dialogue) Are Important To U.S. Issuers and Investors

The U.S. relationship with the EU is extremely strong. Notwithstanding the inevitable disagreements that occur in a close relationship, the U.S. and EU have deep and ever-growing political and economic ties. The health of our respective economies is inextricably connected, with trade and cross-border investment flows linking the transatlantic economies and capital markets. The recent historic enlargement of the EU through the accession of 10 new Member States magnifies the region's importance to the United States.

This relationship provides the global U.S. securities industry and its corporate, institutional and retail clients with tremendous opportunities. Indeed, SIA's largest members engaging in global business receive about 20 percent of their net revenues (excluding interest) from European markets. About 35,000 European employees support these operations. Moreover, their revenues

[2] This will be critical if Europe is to stimulate the development of risk capital. EU Risk Capital Action Plan, http://europa.eu.int/comm/internal_market/en/finances/mobil/risk-capital_en.htm

from Europe are close to double what is earned from their Asian operations. This is clear evidence that the largest U.S. firms are, in the truest sense, global in nature. Another example of the close financial linkages: six of SIA's top-20 member firms (as measured by equity capital) have European parents, including my own.

Fundamentally, the U.S.–EU relationship relies on building common social and public policy goals. The increasing closeness of the relationship is underscored in the statistics and the large trade in financial ideas, talent, technology and capital across the Atlantic; the nascent EU securitization market, U.S.-EU discussions on fair-value accounting and market structure, and improved EU consultation practices, to name just a few examples. In light of these linkages, we commend the Administration, and particularly U.S. Treasury Under Secretary Taylor, Assistant Secretary Quarles, and their staff for opening a specific dialogue with the EU on financial services issues.

The newly expanded EU – with 450-million potential investors and a Gross Domestic Product exceeding $8.6 trillion – is a key market for the U.S. securities industry and its clients.[3]

The two-way flow of trade, portfolio, and direct investment between our two regions exceeds $1 trillion annually – more solid evidence of the partnership cemented between the U.S. and the EU. Importantly, the EU offers U.S. companies an alternative pool of capital for raising debt and equity capital. For example, in 2003 U.S. companies raised more than $171.1 billion in the EU capital market, of which $164.3 billion was in corporate debt issues, and more than $6.8 billion in equity. EU investors have a healthy appetite for U.S. securities and are a major supplier of capital and liquidity to the U.S. market. In 2003, EU investors acquired $225 billion of U.S. stocks and bonds; $33.6 billion in corporate debt, $170 billion of U.S. treasuries and agencies, and $21.3 billion in equity. Impressively, EU-based investors have added $1 trillion of U.S. stocks and bonds to their holdings since 2000.

The EU markets also provide U.S. investors with alternative investment options for purposes of portfolio diversification. For example, U.S. investors own more than $1.3 trillion in foreign stocks, of which over $712 billion, or 53 percent, are EU shares.[4] U.S. ownership of foreign bonds shows a similar emphasis. U.S. holdings of EU bonds totals more than $227 billion, or 45 percent, of total foreign bond holdings.

Without question, the U.S. and EU are each other's most important economic partner. U.S. companies, for example, get half their foreign profits from the European Union. U.S. direct investment in the European Union totaled $700 billion in 2002, and U.S. companies employed more than 3.3 million people in Europe (2001 data). EU investment in the U.S. is also significant. At the end of 2002, EU companies had direct investments in the U.S. totaling nearly $862 billion, or 64 percent of the $1.35 trillion total invested in the U.S. by all foreign nations. Moreover, EU companies based in the U.S. accounted for nearly 3.7 million U.S. jobs in 2001 (most recent data). Two-way trade in 2003 for goods and services totaled $589 billion, accounting for 23 percent of all U.S. trade volume. Clearly, the economic ties are substantial, and will continue to expand, particularly as the new EU accession countries prosper.

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[3] The U.S. and EU equity markets combined account for 70 percent of global stock market capitalization. Not surprisingly then, our respective capital markets also benefit from the cross-border purchase and sale of securities. In 2003, EU-resident investors had transactions (purchases plus sales) in U.S. stocks and bonds of a record $12.8 trillion, resulting in their net acquisition of $225 billion of U.S. securities. Total U.S. transactions in EU securities amounted to about $4.3 trillion, a record, resulting in U.S. net divestitures of EU securities of about $7.6 billion.

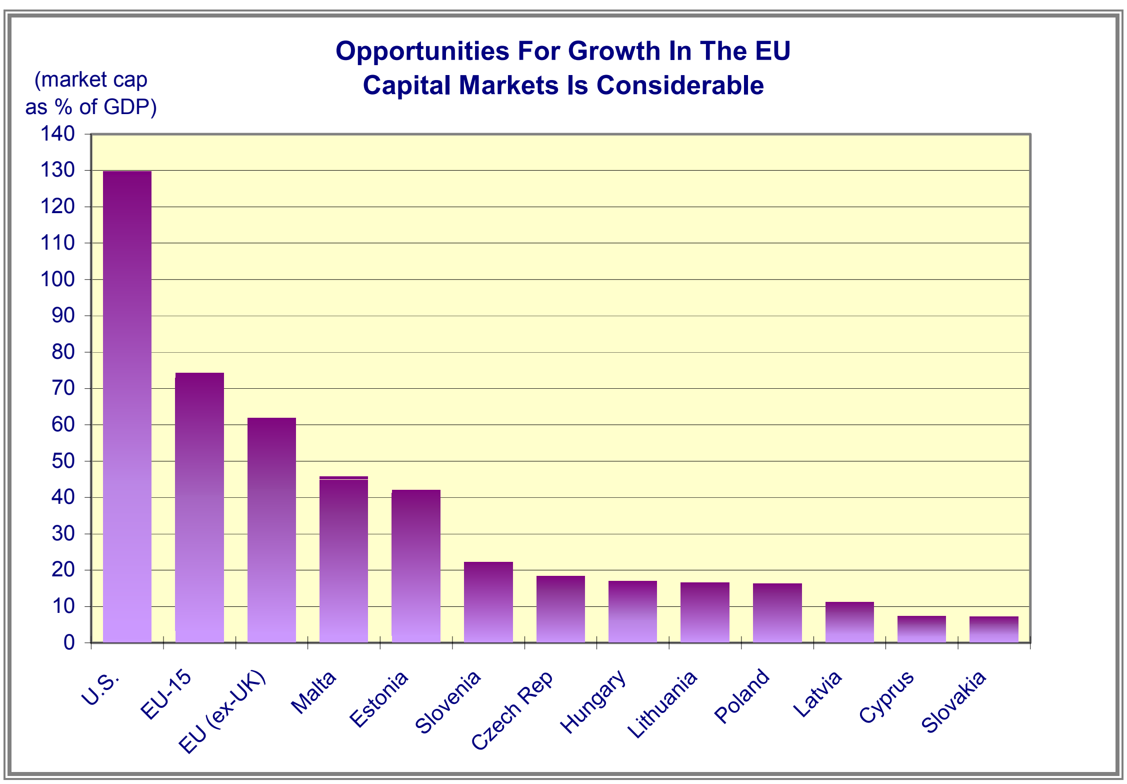
[4] The International Investment Position of the Unites States at Yearend 2002, July 2003, Survey of Current Business, U.S. Department of Commerce, Bureau Of Economic Analysis.

The rationale for the EU's Action Plan becomes clear when comparisons are made about market capitalization: the EU does not (yet) have a single financial market – it continues to be a collection of national financial markets with an overlay of certain significant single-product markets, such as the Eurobond market. The result is that the EU's financial markets are still considerably smaller. By year-end 2003, the market capitalization of the U.S. equity markets totaled $14.3 trillion; almost double the EU total of $7.8 trillion. This tremendous potential for growth helped lead the European Union to conclude that integration of its financial markets should be a key political and economic priority. This, in turn, helped drive the development and pursuit of the FSAP.

U.S. securities firms have long participated in – and been committed to – the EU capital markets. They and their customers have participated directly in the gains that have been made to date, and expect to be among the primary instruments and beneficiaries of a more integrated, efficient EU capital market. The securities industry is extremely optimistic about the future of those markets and is committed to helping realize the full benefits intended by the FSAP.

Developing An Equity Culture

The FSAP, by integrating Europe's capital markets, will stimulate the demand and supply of funds to be intermediated by securities markets. This is critical because EU companies have, of course, traditionally been more dependent on banks for sources of financing through traditional loans. In fact, since the start of the EU single market in 1992, banking assets, as measured as a percent of Gross Domestic Product (GDP), have continued to increase, and ended 2002 at about 204 percent of GDP; the comparable number in the U.S. is 56 percent of GDP. By contrast, U.S. companies seek more capital for financing needs through the securities markets.



For example, the U.S. equity market is about 130 percent of GDP, while in Europe the comparable number is 74 percent.

Behind the FSAP lies the assumption that once the Action Plan is successfully implemented and enforced, EU capital markets will be more efficient, resulting in a broader pool of capital that can support economic growth and job creation. The FSAP will help to create an "infrastructure" for deeper and more liquid capital markets – but it alone cannot broaden the equity markets.

There are, in fact, promising signs of an emerging equity culture for investors in Europe. In the United Kingdom, one out of every three adults now invests in equities. In addition, institutional investors are also increasingly looking to build a greater equity presence by substantially increasing their equity holdings.[5] These trends and others bode well for EU investors and providers of financial products and services, as well as entrepreneurs seeking venture capital. As a result, the implementation of the FSAP – together with common internationally recognized accounting standards, the EU's corporate governance action plan, and improved efficiencies in clearing and settlement – will serve as a catalyst for the development of a Pan-European equity culture.

The recent U.S.-UK Enterprise Forum (May 24, 2004) was a great example of a bilateral attempt to share common experiences on developing a more dynamic "enterprise culture"[6] for which the development of equity investors is critical.[7] However, recent discussions by German and French authorities to create "industrial champions"[8] illustrate the challenges that market forces face within the European Union, and contrast sharply with the market-oriented principles that underpin the FSAP, and could very well impede the ability to realize the full benefits of the FSAP.

Similar issues arose in the Investment Services Directive (ISD) debate on market structure. While the ISD eliminated the "concentration" rule, a number of EU countries supported pre-trade transparency provisions to protect local exchanges, which ran counter to goals of promoting greater competition, choice, and efficiency, and indeed might be a de facto concentration

[5] An OECD study shows a similar trend. European holdings of stocks (as a percent of household financial assets) increased from 14.5 percent (1995) to 21.3 percent in 2000. During the same period, U.S. households increased their holdings form 32.0 percent to 33.1 percent. Household Wealth In The National Accounts Of Europe, The United States And Japan, March 4, 2003. http://www.olis.oecd.org/olis/2003doc.nsf/43bb6130e5e86e5fc12569fa005d004c/91e34dc3d290e515c1256cdf003fa444/$FILE/JT00140238.PDF.

[6] U.S. Treasury Snow opening remarks to the Forum: http://www.treas.gov/press/releases/js1686.htm. Also, see:
a) Chancellor of the Exchequer Brown remarks at http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/chancellorexchequer/speech_chex_240504.cfm; and
b) HM Treasury's website for "Enterprise and Productivity at http://www.hm-treasury.gov.uk/documents/enterprise_and_productivity/ent_index.cfm

[7] Also, note Results of the Competitiveness Council of Ministers, Brussels, 11th March 2004 Internal Market, Enterprise and Consumer Protection issues: "The Council adopted Conclusions welcoming the Commission's Action: The European Agenda for Entrepreneurship" as well as the progress achieved in implementing the European Charter for small enterprises. It identified a range of issues which now need to be taken forward, in particular helping to change attitudes to entrepreneurship through education and training, as well as ensuring that businesses can access the skills base they need to help them to grow; improving the flow of finance for small and medium sized businesses and seeing further progress in the overall regulatory environment. http://europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/04/58&format=HTML&aged=0&language=EN&guiLanguage=en

[8] UK minister hits out at EU "industrial champions", Financial Times, James Mackintosh, May 24, 2004. Also see, Let the market choose Europe's champions, "The key to prosperity is ensuring the right conditions for business investment, particularly in innovative sectors. An essential condition is strong competition." Financial Times, June 13, 2004 by Frits Bolkestein, EU Commissioner for Internal Markets.

rule for certain transactions.[9] The U.S. must work together with its friends in Europe to bridge these differences within the EU and create the environment for private business to flourish, promote market reforms that empower investors and market participants, and allocate capital in a manner that maximizes growth, productivity, and job creation.

Overall, the success of the FSAP is important for the global economy. The U.S. and EU play leadership roles in the international marketplace, helping to set best practices, advocating open and non-discriminatory trade, and acting as engines for global economic growth and job creation. Ultimately, the success of the Action Plan will be determined by how it's implemented, interpreted and enforced by the European Commission and member states. Successful implementation of the FSAP – defined by its ability to create an integrated, deep, transparent, and liquid European capital market – is perhaps best viewed as a perpetual annuity.

A U.S. Action Plan Is Needed To Enhance Financial Markets Dialogue

Looking forward at the next phases of U.S. engagement and the U.S.-EU Dialogue we would suggest a coordinated inter-agency effort – a U.S. Action Plan – to fully and effectively engage EU governments and regulators at all levels about the need for open and competitive markets.[10] As stated before, our goals include: establishment of a Brussels Attaché; increased coordination with the State Department; further U.S. Congress/EU Parliament contacts; and a SEC/CESR coordinated focus on regulatory convergence.

The implementation and enforcement phase of the key capital market directives at the core of the FSAP – as well as other topics under current discussion in Europe such as clearing and settlement, corporate governance, and the examination of rating agencies – will have a direct impact on the U.S. capital markets and U.S. financial services firms operating in Europe. Moreover, the Directives will affect U.S. corporation access to an essential pool of capital for years to come. To ensure that U.S. interests in the European Union are adequately represented, we strongly believe that the U.S. Treasury Department should place a U.S. Treasury Financial Attaché in Brussels. Such a post would advocate U.S. industry interests and support the financial-sector dialogue in which the U.S. and EU are now actively engaged.

A Treasury Attaché in Brussels would make possible much-needed day-to-day dialogue with the Commission and other EU decision-makers as implementation of FSAP progresses; would coordinate with the U.S. regulatory community as appropriate; and would both monitor and study developments of significance to the U.S. financial community in partnership with the industry. The expected pace of change in the EU financial market over the next years, and the complexity of capital markets legislation now in formation, justifies this type of focused presence at the center of the newly expanded EU.

And while we strongly believe a Treasury Attaché in Brussels is needed, we also believe the U.S. State Department, through its Mission to the EU in Brussels, and its Embassies and Consulates in all 25 member states, can enhance and support the U.S. Treasury Department's efforts on behalf of the U.S. financial services throughout the European Union. We believe this effort is

[9] SIA letter to David Wright, December 3, 2003. Also see Linklaters' Financial Markets Group Briefing - April 2004, EU Agrees Revised Investment Services Directive, "However, ISD2 does introduce a new market making obligation for off exchange dealing, which is a significant restriction for those who currently deal as principal in the UK and which may act as a back-door concentration requirement for some transactions."

[10] In Appendix A to this testimony we have detailed our views on the development of the Financial Markets Dialogue, and its importance to the U.S. securities industry.

essential because individual EU member-states can – and often do – play a pivotal role in key EU legislative decisions. Our experience with the Investment Services Directive made this point plain when the European Parliament's amendments to the proposed ISD were reversed (unhelpfully) by a political vote of finance ministers of the member states acting in Council. This reality, and the fact that FSAP measures will be implemented at the member-state level, calls for a U.S. government strategy in Europe.

Treasury clearly has the leadership role in the financial markets Dialogue. However, the State Department has Foreign Service officers with access to, and daily contact with, key government officials in all 25 EU member states – including each of the 10 new member states. Consequently, the State Department is extraordinarily well positioned to be an integral resource for the Treasury Department in these efforts. Increased focus by the State Department, in coordination with the Treasury Department, should therefore be a key element in enhancing U.S. engagement in the Dialogue.

In addition, we firmly endorse the further development of greater understanding and closer relationships between key financial services legislators in the U.S. Congress and the members of the European Parliament (such as the European Parliament Economic & Monetary Affairs Committee, the House Financial Services Subcommittee and the Senate Banking Committee). We believe these efforts should:

1) encourage constructive discussion of existing extraterritorial issues, such as the implementation of the Sarbanes-Oxley Act, and the EU's Financial Conglomerates Directive;

2) facilitate and encourage mutual prior consultation (an "early-warning system") on legislation with potential extraterritorial effects, to help prevent future conflicts; and

3) identify common future legislative goals and common or compatible solutions wherever possible.

Looking Forward: We Need Dialogue At The Regulatory Level On Convergence

The U.S. securities industry strongly supported the pro-active action taken by U.S. and European regulators as part of the U.S.-EU Financial Markets Dialogue – a new regulators' dialogue on regulatory convergence. To date, the Dialogue has been largely reactive, with the U.S. and EU addressing – and resolving – a substantial number of serious and vexing regulatory issues. The current dialogue has been problem driven.

However, we, and the U.S. Securities and Exchange Commission along with the EU's Committee of European Securities Regulators have felt that the Dialogue should be employed for more than just solving problems once they have arisen. We have collectively concluded that the enhanced cooperation and understanding achieved to date can be used pro-actively for the purpose of minimizing regulatory differences or divergences and helping to make the transatlantic capital markets more efficient and accessible.

As a result, we welcome the SEC and CESR terms of reference for the cooperation and collaboration regarding market risks and regulatory projects.[11] SIA's support of such a pro-active

[11] SEC-CESR Set Out the Shape of Future Collaboration, June 4, 2004, "The enhanced relationship between the SEC and the members of CESR has two objectives. The first objective is improved oversight of U.S. and EU capi-

"regulatory dialogue" is consistent with the industry's goal to minimize regulatory differences and improve the efficiency of the transatlantic markets through regulatory convergence.

To this end, SIA has proposed a number of discrete issues that we believe CESR, the SEC, and the industry, working together, could actually resolve in the near-term to the mutual benefit of the transatlantic marketplace. Indeed, in light of the increasingly linked transatlantic capital markets, an uncoordinated approach on these issues could only lead to new regulatory hurdles and barriers that would raise costs for all market participants.

SIA does not seek convergence for its own sake, nor do we believe that all regulations warrant convergence. Differences in our respective regulatory systems often reflect the realities of our different legal systems, different market structures and sometimes even different political choices. As House Financial Services Committee Chairman Michael Oxley noted in his opening statement at last month's hearing, "The choices one country makes for how best to protect its investors and depositors may not always coincide with the choices other countries make. Different policies can be driven by differences in market structure. Such differences are legitimate and do not easily lend themselves to calls for convergence."

However, we do believe that different or duplicative regulation in service of similar or identical policy rationales only complicates the ability of market intermediaries, investors, and those seeking to raise capital to conduct business efficiently. Those areas in which we have suggested that the SEC and CESR study convergence are:

1) public offering documents in the U.S. and European markets – beginning with non-financial disclosure, e.g. Management Discussion and Analysis, reporting of beneficial ownership, real-time event disclosure;

2) U.S. and EU broker-dealer registration requirements;

3) rules relating to credit rating agencies;

4) international anti-money laundering standards that promote uniformity, cooperation and efficacy – beginning with the ability to rely on financial intermediaries across borders to perform due diligence, such as customer identification requirements; and

5) corporate governance standards.

This list illustrates the serious and significant topics that Dialogue should address. Each is complex but provides an opportunity to eliminate unnecessary and unintended inconsistencies in regulatory requirements and, by so doing, contribute to more efficient capital markets.

Lastly, we will briefly discuss an issue of significant concern to the U.S securities industry, the EU's Financial Conglomerates Directive (FCD). In April 2001, the European Commission presented a proposal – a priority measure under the FSAP – for a Directive that would introduce group-wide supervision of financial conglomerates. The proposal was prompted by the continuing consolidation in the financial services sector that has created cross-sectoral financial

tal markets through increased communication regarding regulatory risks to enable regulators to anticipate regulatory problems more effectively. The second objective is to promote through timely discussion regulatory convergence with regard to future securities regulation." http://www.sec.gov/news/press/2004-75.htm groups with activities in both the banking/investment services and insurance sectors. The FCD was adopted in December 2002.

The UK's Financial Services Authority, as the "lead" regulator for virtually all major U.S. firms operating in the EU, will make the equivalence determination. It will do so using guidance to be set forth by the EU Banking Advisory Committee taking advice from the European Commission. Originally, the guidance was to be announced by the end of April 2004, with the FSA scheduled to make its first set of equivalence judgments by June 2004. These timetables have slipped, and we are concerned that U.S. firms could face serious compliance problems. The ability to begin implementation of the Consolidated Supervised Entity regime that the SEC is carefully working on would be jeopardized. We urge the committee to monitor this situation carefully.

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The U.S. securities industry plays an important role in the EU capital markets and is fully committed to the integration of Europe's capital markets. Our competitiveness as a nation and an economy is supported by the ability of our financial services firms to compete openly and fairly. We look forward to working with the U.S. and EU on a positive economic agenda to ensure that European capital market liberalization is achieved in a non-discriminatory manner, and is transparent, efficient, and protects against risk. We very much appreciate the Committee's serious interest in the deepening relationship between the U.S. capital markets and those of our largest trading partner – the European Union. We look forward to working with Congress and the Administration as we work to help create the best possible foundation for the global capital markets.

Thank you very much.

APPENDIX A

The U.S.-EU Financial Markets Dialogue Is Only A First Step

The creation of a single EU financial services market – and the implementation of the Action Plan as a critical step in the realization of that objective – are significant undertakings. The issues raised are numerous and varied and, in many cases, reflect concerns shared on both sides of the Atlantic. While some of these transatlantic issues are a direct result of the Action Plan, others are not and have only been highlighted by the EU's major legislative program for financial services. Whatever their genesis, the Action Plan helped identify the critical need for a Dialogue between the U.S. and the EU focused specifically on financial services issues.

So, in December 2001, as the EU began to consider the specific details of key FSAP Directives, SIA's International Committee wrote to U.S. Treasury Under Secretary John Taylor supporting the creation of a new U.S-EU financial markets dialogue saying – and I quote:

> "The extensive capital markets linkages that have developed between the U.S. and EU make it all the more important that a more formal dialogue be established to supplement the ad hoc contacts that have existed and sufficed up till now."

The letter also said that the International Committee had recently met with John Mogg (Dr. Alex Schaub's predecessor as Director General of DG Internal Market) and had discussed with him the industry's concerns over the European Union's data protection, financial conglomerates, prospectus and market abuse directives.

It might be tempting to say that the familiarity of the items on that list, which looks not unlike a list one might make today, means that three intervening years of U.S.-EU Financial Markets Dialogue have not been very fruitful. But that would be a mistake. To the contrary, in common with the public sector witnesses from both sides of the Atlantic who testified before the full Committee on May 13, 2004, I am here to say that U.S. industry firmly believes that the U.S.-EU Financial Markets Dialogue is successful.

In the absence of the Dialogue, a substantial number of the items on that 2001 list might have easily degenerated into a disruptive – even ugly – "trade-style" dispute with potentially disastrous consequences for both U.S. and EU financial services consumers. Instead, largely because of the Dialogue, each issue has been or is being resolved peacefully and sensibly by the relevant experts and professionals. And, success being the best of advertisements, new potential controversies have continued to be added to the list of issues the Dialogue is being asked to address.

And although the Dialogue was born of necessity – to provide a means of discussing and resolving issues caused by "overspill" – we believe that it should not be, and must not become, simply a means of "alternative dispute resolution". The industry has advocated the development of a dialogue that enables both partners to avoid to the greatest extent possible conflicts in the pursuit of solutions to what are, largely, shared concerns. I will revisit this point in greater detail in a moment.

The Financial Markets Dialogue Must Involve All Constituencies

SIA wrote its letter to Under Secretary Taylor in 2001 because FSAP-related measures, and other actions taken by the EU relating to the financial services, were directly affecting our ability to provide the products and services our customers worldwide demand, as well as our ability to maintain our international competitiveness.[1] And we were growing increasingly concerned that EU legislation, such as the Data Protection and the Financial Conglomerates Directives, could have a detrimental impact on the ability of our firms to compete.

As a result, SIA felt key government officials and regulators on both sides of the Atlantic should begin to discuss transatlantic capital markets issues on an ongoing basis, within an organized – but flexible, and informal – framework that would bring financial officials and regulators together to consult, to solve problems, and ideally to avoid problems before they arose. We were, in fact, concerned that without such a dialogue these complex regulatory issues could lead to tensions or even trade disputes that would impede the efficient flow of capital between the two regions.

For that reason SIA was extremely pleased that government officials at the 2002 U.S./E.U. Summit in Washington, D.C. announced a financial markets dialogue that would include all relevant financial markets participants – a group whose members would change as appropriate depending on the particular issue being addressed.

At A Glance:
U.S. – EU Transatlantic Financial Markets Dialogue

	EU Participants	US Participants
Financial Markets Dialogue	EC	Treasury/SEC/FRB
Securities Regulators	CESR	SEC
Congress/Parliament	EMAC	House Financial Services Committee

CESR = Committee of European Securities Regulators
EC = European Commission
EMAC = Economic and Monetary Affairs Committee

[1] For U.S. firms with a significant EU presence, FSAP Directives and other measure drafted and implemented could have a negative impact our ability to compete in Europe, and, even more worryingly, in other markets around the globe. In fact, we note that the EU Securities Expert Group Report (May 2004), recommends that European legislation and regulation better take into account the fact that investors and issuers frequently taken decisions on a global basis. The Group further notes that the prospectus and transparency directive, while helping integrate the pan-European market, may "…reduce the willingness of third country issuers and investors to raise funds and allocate capital in Europe." "Financial Services Action Plan: Progress and Prospects", Securities Expert Group, Final Report, May 2004.

The Dialogue's recent efforts have been notable and successful with a broadening of participants. They include, of course:

1) The work by the SEC and the European Commission to mitigate the extra-territorial impact of the Sarbanes-Oxley Act;

2) The graceful resolution of concerns over PCAOB registration for which we congratulate Director General Schaub and PCAOB Chairman McDonough, and;

3) The very practical solutions to the Transparency Obligations Directive's accounting standards requirements – grandfathering certain existing bond issues – that will avoid a threat to the liquidity of the European markets against the backdrop of coming accounting standard convergence.

One area where earlier conversations with U.S. market regulators and market participants might have been helpful is in connection with the EU's efforts to update its rules relating to market structure. In our view, the Commission's numerous attempts to balance the merits of pre- and post-trade transparency and on- and off-exchange trading during the revision of the EU's Investment Services Directive could have benefited from greater, deeper, and earlier familiarity with the full range of experiences (both good and bad) of the U.S. markets. Consequently, SIA member firms and U.S. regulators spent a great deal of time with the Commission, EU regulators and legislators helping to craft a compromise ISD revision that seeks to balance, even if imperfectly, the requirements of retail and institutional markets and participants.

Now, with 39 of the 42 FSAP directives and measures introduced and agreed to, the emphasis within the EU (both in Brussels and at the member-state level) will shift to the implementation and enforcement stages. We expect this shift to highlight transatlantic issues that will have to be dealt with imaginatively if the FSAP is to deliver the desired benefits to issuers, investors, and consumers of financial products. It is therefore increasingly important that Congress, the Administration, and U.S. financial services regulators continue and even enhance their engagement in European capital markets developments.[2]

[2] Financial Market Dialogue: United States financial officials, including representatives from the Treasury Department, Securities and Exchange Commission, and the Federal Reserve, are engaged with their E.U. counterparts to ensure that European capital market liberalization is achieved in a non-discriminatory manner and are market transparent, efficient, and protect against risk. http://www.useu.be/TransAtlantic/U.S.-E.U.%20Summits/May0202WashingtonSummit/May0202U.S.E.U.PositiveEconomicAgenda.html.

PROPOSED REGULATION NMS AND THE EVOLVING DEBATE

The Securities and Exchange Commission has proposed a new rule governing the National Market System (NMS) dubbed Reg NMS[1] that touches on many aspects of the U.S. market structure and raises a variety of issues for all market participants. The four major topics addressed in proposed Reg NMS are (1) the ***trade-through***[2] rule; (2) intermarket access; (3) sub-penny pricing; and (4) market data. The Reg NMS proposal provoked such a wide and deep response that the SEC extended the original comment deadline by a month to June 30, 2004. Even before the deadline and the posting of comment letters on the SEC's web site[3], the response to Reg NMS has been significant and varied, as the changes proposed will have a profound impact on the businesses of many market participants and investors, both institutional and retail.

This piece will review the main components of proposed Reg NMS and reactions to it made at both the SEC hearings held on April 21 ("NMS Hearings") and the Securities Industry Association's Market Structure Conference held May 21 ("SIA Conference"), as well as those found in the press and posted comment letters. The following is intended only as a summary of some of the issues raised by the Reg NMS proposal and does not reflect the opinion of SIA. SIA's opinion is presented in its June 30 comment letter to the SEC, which is posted on the SIA web site.[4]

Summary of Proposed Reg NMS

The SEC proposed Reg NMS in February with the goal of modernizing the regulatory framework of the NMS, which was originally mandated in 1975. At the opening of the Reg NMS hearings held in April 2004, SEC Chairman Donaldson described the NMS as having "laid the foundation for competition among markets trading the same securities, while preserving wherever possible and practical the benefits of order interaction and price competition."[5] He named five principles on which the NMS relies:

1. Public display of firm, accessible quotes in a consistent format;
2. Immediate display of orders to trade at or better than a specified price (***limit orders***);
3. Consolidated publication of market quotation and trade data in a form that is both reliable and widely available;
4. Linkages between markets trading the same securities; and,
5. In the exchange markets, rules that are designed to ensure that the best quote is honored before trades are executed at inferior prices.

Donaldson went on to say, however, that while the system has worked well (as demonstrated by the competitiveness and efficiency of the U.S. markets, the development of innovative trading platforms and routing systems, and the growth of investor participation), there were several

1 *Securities Exchange Act* Release No. 49325, February 26, 2004 (www.sec.gov/rules/proposed/34-49325.htm) ("Reg NMS") and Extension of Comment Period Release No. 49749, May 20, 2004 (www.sec.gov/rules/proposed/34-49749.htm) ("Reg NMS Extension").

2 Terms in ***blue bold italics*** are defined in a glossary provided at the end of this piece.

3 Comment letters are available on the SEC web site at www.sec.gov/rules/proposed/s71004.shtml.

4 www.sia.com /2004_comment_letters/1824.pdf.

5 SEC Chairman William H. Donaldson, opening statement at the Regulation NMS hearing, New York, New York, April 21, 2004 (www.sec.gov/news/speech/spch042104whd.htm).

developments over the past decade that "threaten to erode the efficient functioning of the national market system regulatory structure:"[6]

- The development of ***electronic communications networks (ECNs)***: instantaneous execution often does not mesh well with floor-based exchanges (and vice versa);
- The increase in the number of trading venues: it has become more complicated and costly to access them and some charge access fees leading to identical published quotes reflecting significantly different true prices;
- Market-data revenue has become a large source of income for ***self-regulating organizations (SROs)***, leading to strong incentives to maximize behavior that increases revenue, rather than improving actual trading; and,
- Sub-penny price increments have increased the likelihood that trivial price differences are used to step ahead of limit orders, thereby discouraging limit orders.

The following four proposals are the main substantive areas discussed in Reg NMS:

1. a uniform rule for all NMS market centers that, subject to certain exceptions, would require a market center to establish, maintain, and enforce policies and procedures reasonably designed to prevent trade-throughs – the execution of an order in its market at a price that is inferior to a price displayed in another market;
2. a market access rule that would modernize the terms of access to quotations and execution of orders in the NMS;
3. a sub-penny quoting rule that would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment finer than $0.01 per share, except for securities with a share price below $1.00; and,
4. amendments to the rules and joint industry plans for disseminating market information to the public that, among other things, would modify the formulas for allocating plan net income to reward markets for more broadly based contributions to public price discovery.[7]

These, in addition to overall restructuring and modernizing of the rules governing the NMS to promote greater clarity and understanding of the rules, will be discussed, along with related comments, in the following sections.

Trade-Through Proposal

Proposed Reg NMS contains a trade-through rule that extends the current prohibition to apply to Nasdaq-listed shares, in addition to New York Stock Exchange-listed (NYSE) and American Stock Exchange-listed (Amex) shares. The rule also would apply to all order execution facilities, including internalized broker-dealer execution facilities that are not necessarily in the public quote. In order to gain trade-through protection, bids and offers must meet certain access standards. The proposed rule contained several exceptions to the trade-through prohibition including customer opt-out and automated order execution (subject to certain price standards).

The trade-through rule has generated perhaps the greatest amount of coverage as it gets to the heart of the NMS and how one defines "best execution." Is best execution defined by best price only? Speed and certainty? Some combination of best price and speed? Further, how to agree

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6 Ibid

7 Reg NMS, p. 1.

on how fast is fast enough? To some participants at the SIA Conference, milliseconds were crucial, but to others one second was adequate. Related questions involve how to define fast vs. slow markets, or whether it would be better to look at 'fast' quotes (i.e., automatically executed, no human intervention) vs. 'slow' quotes (i.e., manually executed).

Other questions raised regard the opt-out feature. If customers can easily opt-out, then what is the point of a rule? Some participants have remarked that onerous restrictions, however, could stifle well-established trading conventions such as block trading and benchmark trades (such as volume weighted average price and derivatives-related trades). Furthermore, others have commented that requiring the broker to provide disclosure of a hypothetical national best bid or offer ("NBBO") at the time of an opt-out trade is not consistent with requirements for accuracy because there is no way to be sure that the client could have executed at such a hypothetical price if the client had not "opted out."

These and many other questions were made somewhat moot by the NYSE announcement that it intends to expand its ***automatic execution (auto-ex)*** facility. If the majority of NYSE trades will be fast (automated), and only those fast quotes are protected by the trade-through rule, then most of the disagreements appear to fall away. Those market participants who currently deal in the automated world will not be comfortable with the manual world of the trading floor and vice versa, but if slow (manual) quotes are not protected and automated quotes are properly linked, then it shouldn't matter. Needless to say, it is too early to tell how market participants will react to this development in their comment letters, but some have remarked that if the system works as described, many of the issues concerning fast vs. slow markets may evaporate.

Market Access Proposal

The three main subjects of the market access proposal are (1) standards for market access; (2) limitations on access fees; and, (3) standards to address locked or crossed quotes. Under proposed Reg NMS, "***quoting market centers*** and ***quoting market participants*** would not be permitted to impose unfairly discriminatory terms that inhibit non-members, non-subscribers, or non-customers from obtaining access to quotations and the execution of orders through their members, subscribers, or customers. Moreover, a quoting market participant would be required to make its quotations accessible to all quoting market centers and all other quoting market participants on terms as favorable as those it grants to its most preferred member, customer, or subscriber."[8] The SEC would not establish the linkages necessary, but would rather rely on the marketplace to do so.

There seems to be general agreement among SIA Conference participants that more and better linkages are necessary for better intermarket access, which in turn is a prerequisite for being able to access the best price as required by a trade-through rule. There are, however, differences in opinion whether those linkages should be private, such as those in the Nasdaq market, or public, such as the ***intermarket trading system (ITS)*** (or a new and improved ITS). There is also a range of opinion as to whether and at what point smaller participants should be required to participate in a public execution facility.

As for access fees, the issue is particularly important when considering that two identical quotes may represent two very different trades because of access fees. According to the NMS release, unseen fees are the reason behind the more frequent occurrence of ***locked*** or ***crossed markets***. Among the several possible solutions, the proposal suggests a de minimis fee as the best choice.

[8] Reg NMS, p. 118.

To deal with the level of fees, the proposal caps access fees at a de minimis amount of $0.001 per share for any individual market participant and a total of $0.002 per share in any single transaction. The proposal further encourages SROs to adopt rules that discourage participants from crossing or locking markets.

While there appears to be agreement among market participants that a solution is needed, there is disagreement over whether the SEC should be setting fees at all, or whether fees should be set by the market. As an alternative to setting a fee cap, Annette Nazareth, SEC Director of Market Regulation, suggested that perhaps high fee quotes should be identified as such on the consolidated tape in the same way as an inaccessible quote and therefore be "excluded from protection under the trade-through rule, eliminated from the allocation of market-data revenue and subject to locking quotations from market centers with de minimis fees."[9] Although access fees are important to some business models, but antithetical to others, some have commented that a compromise de minimis fee might be an important step towards a middle ground.

Sub-Penny Pricing Proposal

Currently, while most major markets use a minimum quoting convention of $0.01 per share, ECNs display sub-penny quotations on their proprietary systems. While broker-dealers can access the sub-penny quotes, the quotes are rounded in the quotation data available to the public. The commission has characterized this as "creating 'hidden markets' where securities trade at prices not transparent to the general public."[10] The Reg NMS proposal goes on to describe that such sub-penny quotes are often used to step-ahead of existing limit orders by negligibly improving the price. The choice described in the release appears to be to either upgrade all market displays to have sub-penny display (eliminate the need for rounding) or set a one-penny standard increment for all market participants.

The Reg NMS release addresses the issue of sub-penny pricing with a proposal to prohibit the display of orders in increments of less than $0.01 per share, other than for those with a share price below $1.00. The proposal seeks to "ensure that a market participant can only receive execution priority over standing limit orders by improving the best displayed price by more than a nominal amount (i.e., by at least a penny per share)."[11] This rule would not prohibit trades occurring at sub-penny prices, but only the posting or accepting of orders at smaller increments.

There appears to be general support for this proposal, although some have commented that the SEC should not be mandating minimum price increments as it might result in increased costs to investors.

Market Data Proposal

Market data is said to be the lifeblood of the securities markets: it is created by market participants' quotes and trades, consolidated, and then sold back to market participants. SRO members participate in three different networks (the "Networks"), whose fees are approved by the SEC. The networks then allocate the fees among their participants. Proposed Reg NMS asks for comment on three alternative configurations for the gathering and disseminating of market data.

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[9] Annette Nazareth, remarks before SIA Market Structure Conference, New York, NY, May 21, 2004.

[10] Reg NMS, p. 144.

[11] Reg NMS, p. 173.

Market data is a huge source of the exchanges' revenue, but arguably costs relatively little to collect and disseminate. According to the SEC, the Networks' 2003 net income was $386,027,000 compared to expenses of $38,300,000.[12] This mark up highlights complaints that the current fee levels are excessive in relation to costs, and backs up the complaint that instead of merely paying for a "utility" function of compiling and disseminating data, market participants are subsidizing the running of the Network members – including the SRO functions. Some comments pointed out that although SRO regulation should have solid, reliable funding, it should not come from market-data fees, which should be as low as possible and cost-based. Some have pointed out that, in fairness, it is not currently possible to say with certainty what the fees are paying for because the market-data costs are not transparent. The SEC, along with many market participants, has commented that it wants to see the exchanges adhere to the same level of disclosure that their listed companies adhere to. Transparency in costs and fee setting would allow a fuller and more educated discussion of market-data fees.

The NMS proposal also offers a new way of calculating the allocation of market-data fees collected that rewards not only trade execution, but also price quoting and the improvement of quoted prices. While some participants have complained about the complexity of the proposed formula for allocating market data revenues to the SROs, the SEC stated that it is confident that the formula is workable. Several participants at the SIA Conference agreed that the formula appeared to be an improvement over existing formulas. However, more than the way income is allocated, many participants have stated that market-data fees are simply too high. It has been suggested that one way to lower the data fees would be to have only limited consolidated data (NBBO) at a very low price, and allow the Networks' members to sell the rest of their data in the open market.

Other Issues

The NMS proposal also deals with the overall issues of market governance and transparency. At the SIA Conference, one panel debated self-regulation and the existing SRO structure, and came to the general conclusion – to paraphrase one participant – that SROs are the worst method of regulation, except for everything else! That said, there were a variety of suggestions regarding how to improve the current self-regulatory system ranging from a hybrid-SRO proposal[13] to consolidating only some limited surveillance functions. Most participants cited improved transparency of costs and operations as a key issue in improving governance.

This summary is intended to merely highlight some of the very complicated and important issues of U.S. market structure reform as raised by the release of Reg NMS, the NMS Hearings and the SIA Conference. Fuller and more developed discussions and opinions can be found in the formal comment letters posted on the SEC web site, and in particular, the June 30 SIA comment letter, which is posted on the SIA web site.[14]

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[12] Reg NMS, p. 203.

[13] See SIA White Paper at http://www.sia.com/testimony/html/white_paper1.html

[14] www.sia.com/2004_comment_letters/1824.pdf

Glossary[15]

Alternative Trading System (ATS): Alternative trading system means any organization, association, person, group of persons, or system that: (1) constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange and (2) does not: (i) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or (ii) discipline subscribers other than by exclusion from trading.

Automated Order Execution Facility: An order execution facility that provides for an immediate automated response on all incoming subject orders for up to the full size of the best bid and offer disseminated pursuant to an effective national market system plan without restriction on execution.

Automatic Execution (Auto-ex). Auto-ex is defined as an immediate automated response (with no human intervention) to an incoming order that the order was executed in full or in part, or could not be executed because of prior execution of the displayed order.

Electronic Communications Network (ECN): Any electronic system that widely disseminates to third parties orders entered by an exchange market maker or over-the-counter (OTC) market maker, and permits such orders to be executed against in whole or in part.

Intermarket Trading System (ITS): A computer system that interconnects competing exchange markets for the purpose of choosing the best market. ITS is operated by the Securities Industry Automation Corporation (SIAC).

ITS Plan. The ITS Plan, originally approved by the SEC in 1979 and since amended, requires members of an exchange to avoid trade-throughs. The current rules apply to exchange members and registered market makers who traded NYSE- and Amex- listed shares. There is no such rule in respect to the trading of Nasdaq securities.

Limit Orders: A limit order is an order to buy or sell a predetermined number of shares at a specified price or better than the specified price. Limit orders also allow one to limit the length of time an order can be outstanding before being cancelled.

Locked or Crossed Markets. Locked or crossed markets occur when the bid and offer quotes of a security are displayed at the same price, indicating either that one or the other's quote is not valid, that brokers are not diligently representing their clients, or that inefficiencies exist that deter trading with the quoting market. Quotes also may lock, however, because one or both quotes have an access fee attached, which increases the net price of trading with that quote, and creates an undisclosed spread. Quotes also may lock due to the different speeds of market centers. At times, automated markets may lock the quotes of manual markets instead of attempting to trade with those quotes.

[15] Definitions are from the NMS proposal itself and other related releases and comment letters.

NMS Stock: NMS stocks, according the proposed Reg NMS, would include NYSE-, Amex- and Nasdaq-listed stocks. Currently, intermarket trade-through restrictions apply only to exchange-listed equities, under SRO rules adopted pursuant to the ITS Plan.
Order Execution Facility: Any exchange market maker; OTC market maker; any other broker dealer that executes orders internally by trading as principal or crossing orders as agent; alternative trading system; or national securities exchange or national securities association that executes orders.

Quoting Market Centers. An order execution facility of any national securities exchange or national securities association that is required to make available to a vendor its best bid or offer in a security pursuant to § 242.602.

Quoting Market Participants. The term quoting market participant is defined as any broker or dealer that provides its best bid or offer in a security to a national securities exchange or national securities association pursuant to § 242.602 or Regulation ATS (§§ 242.300 through 242.303), and whose best bid or offer is not otherwise available through a quoting market center.

Self-Regulating Organizations (SROs): An entity, such as the NASD or NYSE, responsible for regulating its members through the adoption and enforcement of rules and regulations governing the business conduct of its members.

Trade-Through: The purchase or sale of an NMS stock during regular trading hours, either as principal or agent, at a price that is lower than the best bid or higher than the best offer of any order execution facility that is disseminated pursuant to an effective national market system plan at the time the transaction was executed.

ECONOMIC UPDATE AND OUTLOOK

Summary

Real gross domestic product (GDP)[1] grew 3.9% at an annual rate in the first quarter of 2004 (1Q'04), which was slightly below the 4.1% rate in 4Q'03, and similar results are estimated for 2Q'04. Over the near term, growth is expected to steadily decelerate, reflecting first the dissipation of past fiscal stimulus and later, the lagged effect of the gradual withdrawal of accommodative monetary policy.

Real GDP and Its Components

(annual average percent change, unless otherwise noted)

U.S. OUTPUT	2000	2001	2002	2003	2004(f)	2005(f)
Real GDP	3.7	0.5	2.2	3.1	4.3	2.6
Private Consumption	4.7	2.5	3.4	3.1	3.9	2.5
Business Investment	8.7	-4.5	-7.2	3.0	7.6	3.5
Residential Investment	0.8	0.4	4.9	7.5	5.8	-2.3
Government Spending	2.1	2.8	3.8	3.3	2.6	2.5
Exports	8.7	-5.2	-2.4	2.0	9.2	7.0
Imports	13.1	-2.6	3.3	4.0	8.6	4.0
Net Exports*	-379.5	-398.1	-470.6	-509.1	-546.8	-534.8
Change in Inventories*	56.5	-36.0	5.7	-0.7	62.0	0.0
Personal Consumption Expenditures Deflator	2.5	2.0	1.4	1.8	2.5	3.4

*In billions of chained 2000 dollars.
Source: Bureau of Economic Analysis (BEA)

Strong real GDP growth of 4.3% is projected for full-year 2004, up from 3.1% for 2003. Total nonagricultural employment is projected to rise 1.2% in 2004, following a decline of 0.2% in 2003. The U.S. unemployment rate is expected to decline to 5.5% by year-end and average 5.7% in 2004, compared to an average of 6.0% in 2003. Personal income is expected to increase 4.5% in 2004, following an increase of 3.2% in 2003. Next year, real GDP is forecast to rise 2.6%, with the deceleration principally reflecting the impact of higher interest rates and prices for fuel and other primary products. Unemployment is expected to stabilize at 5.5% and inflation is expected to rise moderately to an average of 3.4% from 2.5% this year.

The Recovery Extends Through the First Half of 2004

Background – What a difference a year makes. Last summer the climate of uncertainty prevailing in early 2003 was dispelled, and business and consumer confidence strengthened into the new year. Real GDP growth surged, and corporate profits and equity prices rose at a near-record pace in late 2003. This was in response to the easing of concerns and arrival of additional monetary and fiscal stimulus at mid-year, the effects of which spurred growth through the first half of 2004. Business investment, after declining for nine straight quarters, began growing again in 2Q'03, rebounding at a strong 9% real average annual rate over the past four quarters.[2]

1 Total GDP in 1Q'04 in billions of current dollars was $11,451.2, while total real GDP and the change in real GDP in during 1Q'04 measured in billions of chained (2000) dollars were $10,712.1 and $112.0, respectively.

2 2Q'03 through 1Q'04.

Growth of real consumer spending jumped, supported by rising employment, real wage gains, lower interest costs, reduced taxes and positive wealth effects. A surge in residential investment, along with stronger growth of defense spending, also contributed, albeit more modestly, to the quickening pace of economic growth. The combined impact of declines in the dollar and accelerating growth in the world economy increased the demand for U.S. exports in 2004, but this was more than offset by still strong import growth.

First Quarter Revisions – Real GDP grew 3.9% at an annual rate in 1Q'04,[3] according to revised figures released June 25. This result was slightly weaker than the 4.1% rate in the final quarter of last year, and 0.5 percentage point ($13.9 billion) lower than the preliminary estimate for 1Q'04 issued last month. The slight deceleration of growth in 1Q'04 was largely due to more moderate increases in investment in business equipment and software and in residential housing, and slower growth in exports, which were only partially offset by slower import growth and a slight pickup in consumer and federal government spending.

1Q 2004 Real GDP and Its Components

(annual average percent change, unless otherwise noted)

	Percent of Total	Contribution to Growth of Real GDP*	Growth of Real GDP vs. 4Q'03	Growth of Real GDP vs.1Q'03
Total Real GDP	100.0	3.90	3.9	4.8
Personal Consumption	70.3	2.64	3.8	4.3
Durables	8.4	-0.32	-3.7	9.9
Nondurables	20.3	1.36	6.9	5.2
Services	41.6	1.61	3.9	2.8
Business Fixed Investment	10.3	0.54	5.3	8.9
Equipment and Software	8.0	0.71	9.2	12.4
Structures	2.3	-0.18	-7.4	-1.7
Residential Investment	5.4	0.24	4.6	9.5
Government Spending	18.5	0.54	3.0	3.0
Exports	10.0	0.72	7.5	8.9
Imports	-15.1	-1.43	10.4	9.0
Change in Inventories	0.3	0.65	- -	

* In percentage points of real GDP at seasonally adjusted annual rates.
Source: BEA, www.bea.gov/bea/rels.htm. Subtotals may not add to totals due to independent rounding.

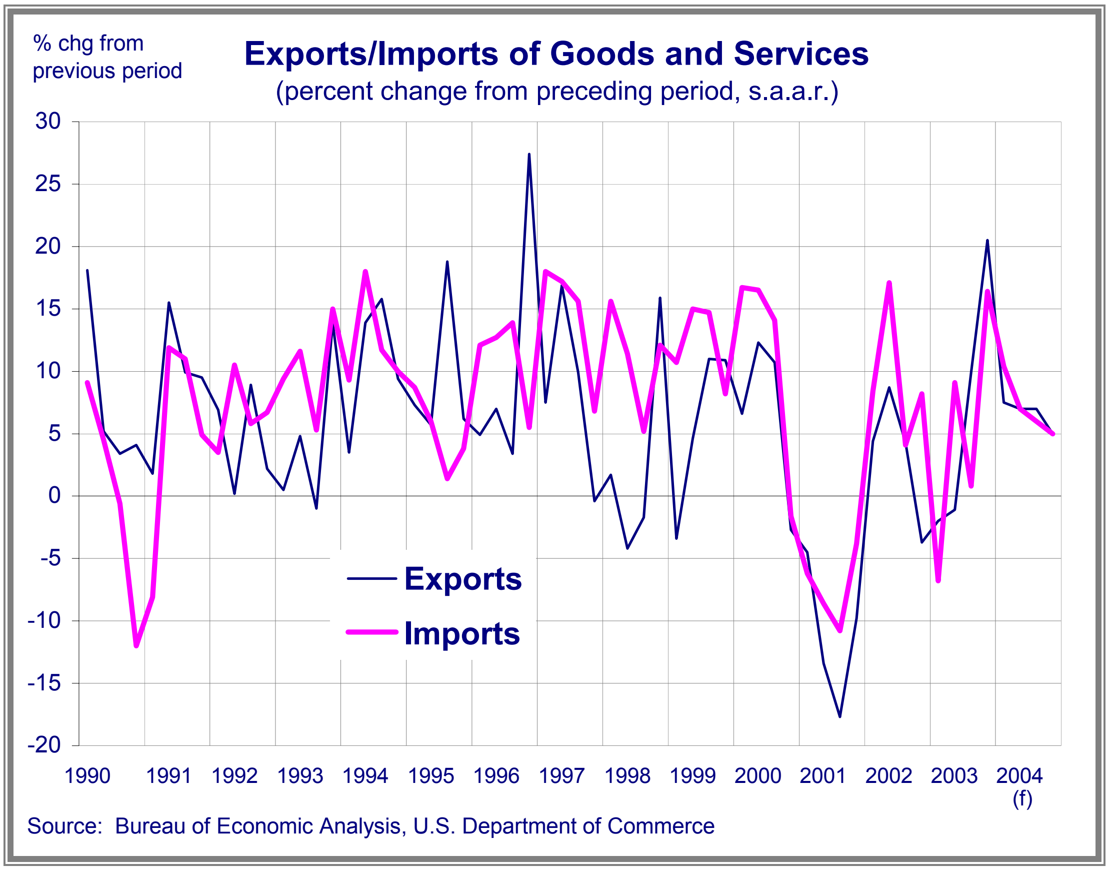
Real consumer spending increased 3.8% in 1Q'04, compared with a rise of 3.2% in the final quarter of 2003, as spending on services and nondurable goods more than offset a slump in durable goods purchases. Durable goods purchases, led by motor vehicle sales, had a tremendous 28.0% surge in the third quarter, as incentives "borrowed against future demand," before rising only 0.7% in 4Q'03 and contracting 3.7% in the first three months of 2004.

Real residential fixed investment increased 4.6% in 1Q'04, which was well below the 7.9% pace in 4Q'03, after booming growth of 21.9% in 3Q'03. Real growth of household spending (the sum of consumer spending and residential construction), which has provided the principal

[3] Unless otherwise noted, this and other rates of growth for real GDP and its components are the percent change from the preceding period at seasonally adjusted annual rates.

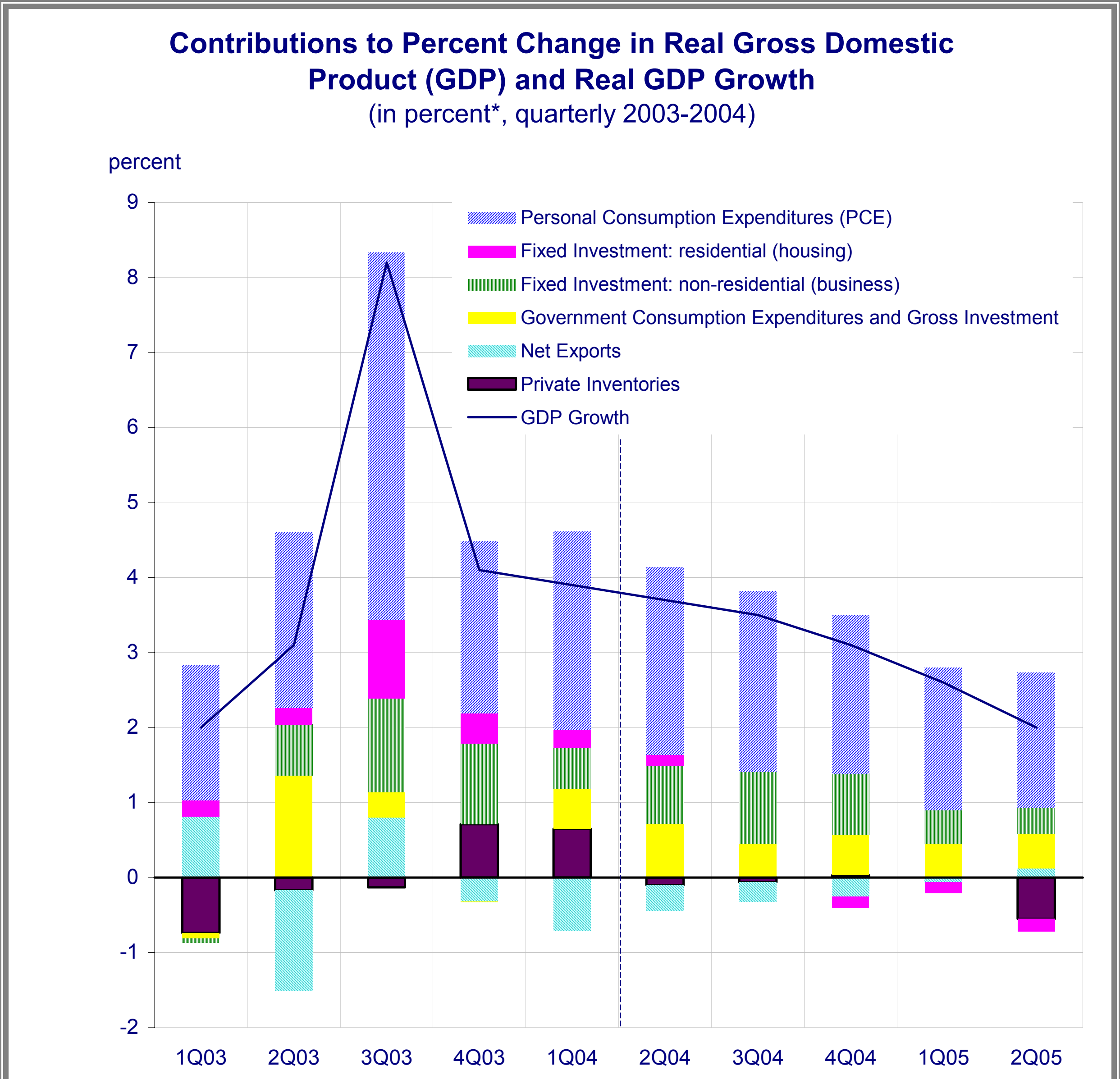
support for the economy for most of the past three years, rose 3.8% in 1Q'04 (compared to 7.8% and 3.5%, respectively, in 3Q'03 and 4Q'03). This, and an increase in the personal savings rate, was accommodated by strong growth in real disposable personal income (DPI)[4] and, to a lesser extent, by additions to already worrisome levels of household debt. Real DPI rose at a 4.9% annual rate in 1Q'04 and was 4.4% higher than the same period a year earlier.

Similarly, growth of business investment also slowed in 1Q'04. Real business investment grew at an annualized rate of 5.3% in 1Q'04, following growth that averaged 10.2% in the last three months of 2003. This rebound, following declines in total business investment since the end of 2000, was due solely to increased investment in equipment and software, which rose 9.2% in 1Q'04 after averaging 13.5% over the final three quarters of last year. The other major piece of business capital spending, investment in non-residential structures, continued to slump. In 1Q'04, spending on structures contracted a further 7.4%, at an annual rate, the tenth consecutive quarterly decline in this critical category of business spending, producing a cumulative decline of 24.1% over the last three years.



Net exports of goods and services (exports minus imports) shaved 0.71 percentage points from the overall rate of expansion for the economy in the first quarter of this year, reversing limited improvements seen last year. Export growth slowed to a 7.5% annualized growth rate in 1Q'04, after surging 20.5% in 4Q'03, as U.S. trade performance, with appropriate lags, began to reflect

[4] Real disposable personal income is personal income, less current taxes and government social insurance contributions, adjusted to remove price changes.



*percentage change from preceding period at s.a.a.r.
Source: Bureau of Economic Analysis, U.S. Department of Commerce

the significant on-going decline in the value of the dollar, particularly against the euro, and a pickup in foreign demand as global growth strengthened. Further improvement in the trade deficit has been stymied, in part, by the efforts of Asian monetary authorities that have, thus far, prevented the dollar from declining against their currencies to levels more reflective of economic fundamentals and more in line with market forces. However, strong growth of final domestic demand in the U.S. spurred import growth, which rose to 10.4% in 1Q'04, more than offsetting the positive impact of higher exports.

Government spending continued to grow, albeit at a slightly slower 3.0% annual rate, compared to the 3.3% growth rate seen in calendar year 2003. Government spending growth, which was solely due to higher defense spending, made a positive contribution to overall growth of a half a percentage point. Federal non-defense spending and spending by state and local governments fell in real terms.

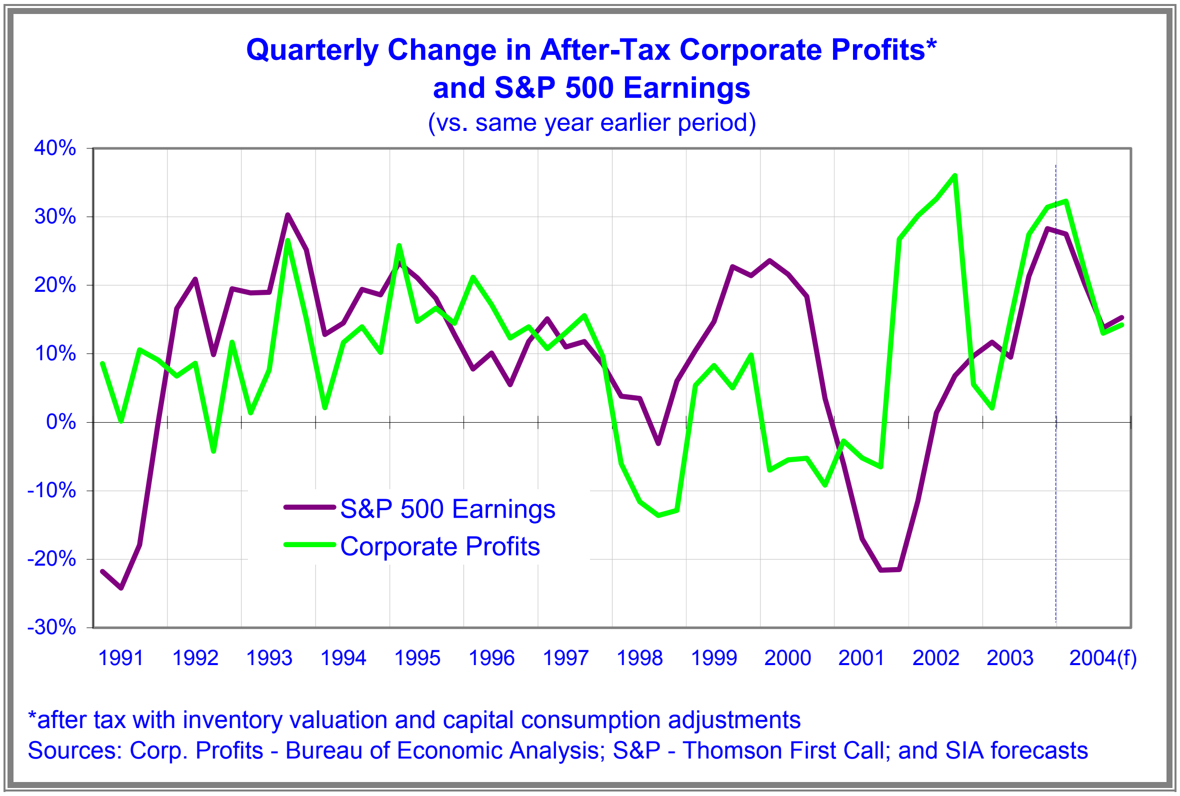
Meanwhile, private inventories increased $25.5 billion, which contributed 0.65 percentage points to overall real GDP growth of 3.9% in the first quarter of this year. This is similar to the positive contribution of 0.71 percentage points that inventory accumulation made to growth in 4Q'03. Real final sales of domestic product, a measure of GDP that excludes inventory changes, rose 3.2% at an annual rate in 1Q'04, a slight deceleration from a 3.4% pace in 4Q'03.

Second Quarter Estimates – Estimates for 2Q'04 are similar to results reported for 1Q'04. The recovery, which became more balanced across the course of last year by finding broader support in the long-awaited revival of business investment and exports, remained on track. Without further inventory accumulation, real GDP grew at an estimated 3.7% annualized rate in 2Q'04. This pace is slightly below the growth of real GDP in the preceding quarter, but actually is ahead of the pace of the two previous quarters if the positive contribution of inventory accumulation were excluded. This measure, real final sales of domestic product, rose 3.4% in 3Q'03 and 3.2% in 4Q'03.

Consumer spending growth is estimated to have remained strong, although slowing slightly to an annualized rate of 3.7%, led by growth in consumption of services and non-durable goods. Retail sales stayed surprisingly strong, supported by further gains in real disposable income. Consumer purchasing power was boosted by a combination of sizable tax refunds, real wage gains and more rapid job growth in April and May.

Growth of residential investment is also estimated to have remained strong, picking up slightly to a 4.7% annualized rate in 2Q'04, as home sales surged to record levels in May. Housing continues to benefit from what may prove to be the last wave of mortgage equity withdrawals and from purchasers moving aggressively to lock in relatively low fixed mortgage rates before interest rates move higher.

Business investment growth is believed to have accelerated in 2Q'04 to 7.0%, after slowing somewhat in the preceding period. Spending on non-residential structures expanded marginally, and growth in investment in equipment and software remained strong, in response to above-average growth rates in corporate profits, still-low interest rates, and expectations of continued solid expansion of final demand.



The yawning U.S. trade deficit, which is equivalent to a record 5.0% of GDP, continued to expand, but the increase in this fundamental imbalance slowed during 2Q'04. The negative contribution that net exports made to overall growth in 2Q'04 was more than offset by increased government consumption expenditures, again led by defense spending growth.

The Outlook: Slower Growth and Rising Inflation

As we enter the second half of 2004, growth is expected to slow as the impact of fiscal stimulus fades and monetary accommodation is withdrawn. Real GDP growth is expected to gradually decelerate across the course of this year, from 3.9% in 1Q'04 to 3.1% in 4Q'04. The threat of deflation, which preoccupied U.S. monetary authorities a year ago, before being seen as " virtually nil" as 2004 began, has now been replaced by concerns that the Federal Reserve may be "behind the curve" in responding to the signs of renewed inflation with its first of a series of interest-rate hikes. Until recently, persistent slack in the economy, which can still be seen in significant unutilized capacity in a number of industries and in labor markets, continued strong productivity growth, and a lack of pricing power had kept inflation moderate. However, this has begun to change, with rising unit labor costs in response to renewed job growth and a jump in oil and other commodity prices helping to boost inflationary expectations and leading to an increase in core consumer prices. In response, the Fed funds rate was raised to 1.25% from 1.0%, its lowest level since 1958. It is assumed the Fed will follow its first increase in four years with additional quarter-point interest-rate increases on August 10 and November 11 of this year, and with three similar hikes in early 2005.

Real GDP and its Components

(quarterly average percent change, unless otherwise noted)

U.S. OUTPUT	2002 1Q	2002 2Q	2002 3Q	2002 4Q	2003 1Q	2003 2Q	2003 3Q	2003 4Q	2004 1Q	2004 2Q(e)	2004 3Q(f)	2004 4Q(f)
Real GDP	4.7	1.9	3.4	1.3	2.0	3.1	8.2	4.1	3.9	3.7	3.5	3.1
Private Consumption	4.1	2.6	2.0	2.2	2.5	3.3	6.9	3.2	3.8	3.7	3.4	3.0
Business Investment	-7.0	-3.0	-1.1	-0.1	-0.6	7.0	12.8	10.9	5.3	7.0	6.0	4.0
Residential Investment	8.7	8.9	4.2	6.8	4.5	4.5	21.9	7.9	4.6	4.7	0.0	-3.0
Government Spending	4.6	4.0	2.5	7.1	-0.4	7.4	1.8	-0.1	3.0	3.5	2.5	3.0
Exports	4.4	8.7	4.3	-3.7	-2.0	-1.1	9.9	20.5	7.5	7.0	7.0	5.0
Imports	8.4	17.1	4.1	8.2	-6.8	9.1	0.8	16.4	10.4	7.0	6.0	5.0
Net Exports*	-431.2	-467.6	-471.9	-511.5	-490.0	-526.0	-505.2	-515.2	-535.6	-544.7	-550.1	-556.8
Change in Inventories*	-23.5	-8.0	32.8	21.5	1.6	-4.5	-9.1	9.0	25.5	-0.18	-0.06	0.03
Personal Consumption Expenditures (PCE) Deflator	0.7	2.9	2.0	1.7	2.8	0.5	1.8	1.0	3.2	3.5	3.4	3.7

*In billions of chained 2000 dollars (at seasonally adjusted annual rates).

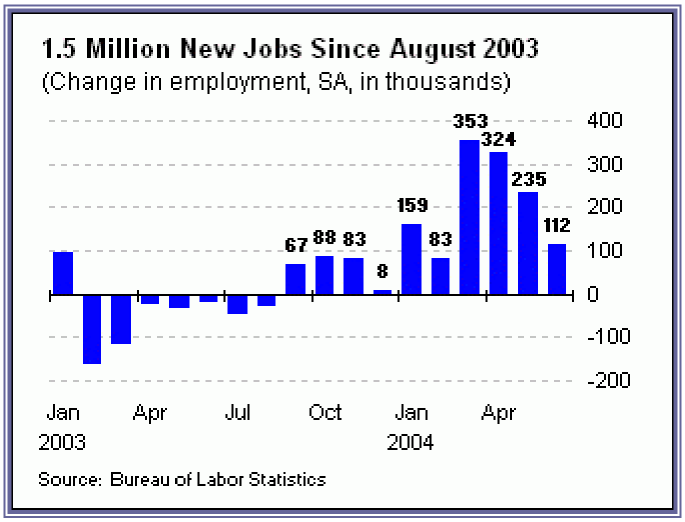
Source: Bureau of Economic Analysis and SIA estimates and forecasts.

Consumers are expected to respond to this "measured" pace, but only with a significant lag. Growth of real consumer spending should remain strong, albeit gradually decelerating, in late 2004. This deceleration reflects the drag on consumers' discretionary spending exerted by higher food and fuel prices and the gradually rising costs of servicing historically high levels of household indebtedness, which is partially offset by continued wage and job growth, and ongoing but more modest mortgage equity withdrawals. Growth of residential investment is expected to halt then decline at year-end, leading the slowdown into 2005.

Capital spending plans for 2004 have been expanded in response to strong growth in corporate profits, but less so than recent and expected performance would suggest, as a substantially higher proportion of retained earnings is directed towards stock buybacks and discretionary compensation increases. Despite an improvement in sentiment, businesses remain cautious about expansion given the continued presence of slack capacity in a number of industries, a belief in ongoing improvements in productivity, and expectations of slowing growth late in the year. Caution is also apparent in patterns of investment that are directed more to achieving cost savings than output increases, as the bulk of planned business spending appears to be aimed at maintaining recent above-trend rates of productivity growth, rather than at boosting productive capacity through the expansion of physical plant. The nascent recovery in business investment is unlikely to be robust given prospects for higher interest rates and slowing growth of aggregate final domestic demand.

Export growth is expected to remain a small, albeit growing contributor to the ongoing, but fading, recovery, more than offsetting continued high, though slowing, import growth. Asian exchange rate policies and large U.S. trade imbalances with countries in that region are expected to persist, while the overall current account deficit of the United States, already at worrisome levels, should begin to stabilize late this year.

These forecasts depend critically upon assumptions about the size and pace of Fed interest rate increases, detailed above, which are more than fully priced into the markets. How aggressively and how frequently the Fed actually moves depends on whether assumptions about the evolution of several variables prove to be correct. These assumptions include that (a) the recent rise in inflation, inflationary expectations and leading indicators of inflation continue to produce acceleration in core consumer prices and (b) the clear, sustained pickup in the job market continues (despite disappointing June numbers), in lagged response to above average growth enjoyed in the past year. The timing and magnitude of upcoming increases in interest rates will remain tied to the actual evolution of inflation and resource usage. It is worth noting that the only change in the Fed's recent statement accompanying the rate hike was meant to enhance its highly valued flexibility to move if and when it deems necessary and to continue to tie any change in monetary policy and interest rates to the evolution of economic data on employment and inflation in the "next quarters."

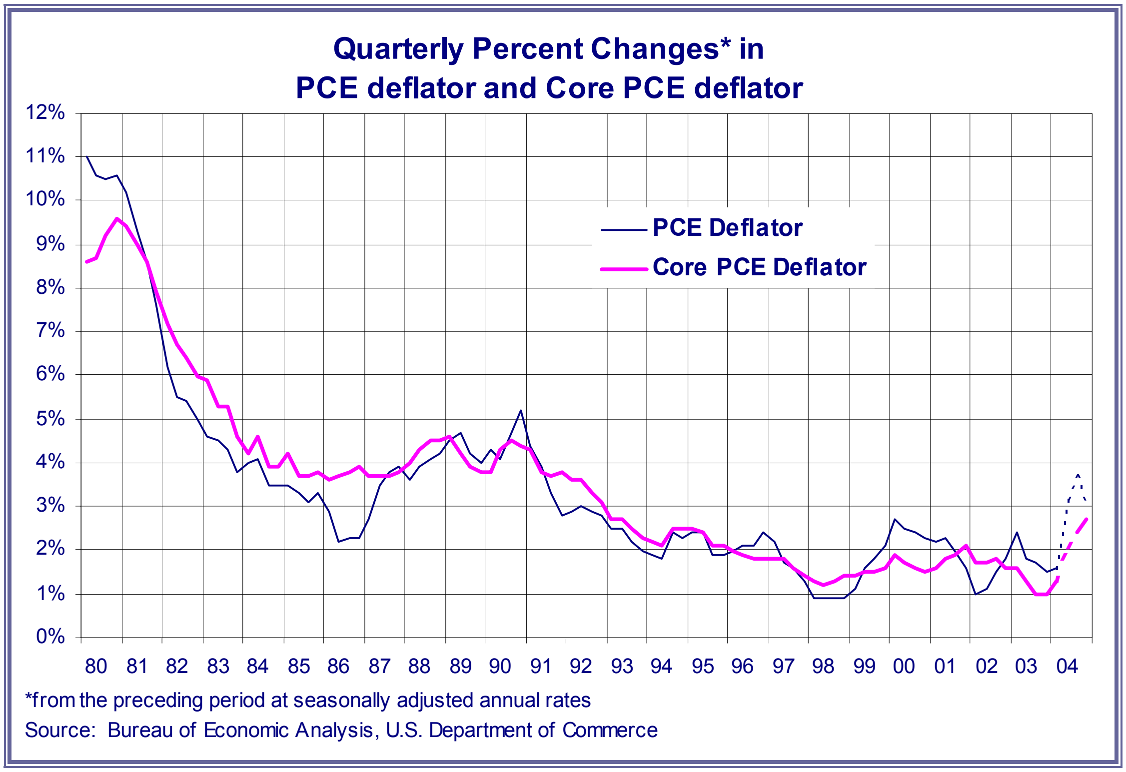


The Return of Inflation: Pig in the Python or Price Spiral?

Inflation is clearly picking up. The 12-month rate of consumer price inflation rose to 3.1% last month, up from 1.7% in February. Since the start of this year, consumer prices have risen at an annualized rate of 5.1% and at a 5.5% pace over the last three months. While most of the increase is coming in the form of higher fuel (particularly oil) and food prices, the core rate (excluding more volatile food and fuel prices) is up too, rising to 1.7% in May from 1.1% at the end of last year and has climbed at a 3.3% annualized rate over the last three months. In June, the overall rate of consumer price inflation was more moderate as fuel prices retreated, but the core rate is expected to have accelerated further.

Meanwhile, producer prices jumped 0.8% in May, the biggest monthly move in 14 months, and have been rising at an 8.3% annualized rate over the past three months. The increase in May was largely due to a surge in food prices (up 1.5% after a 1.4% increase in April) and energy prices (up 1.6% in each of the last two months), as the core rate rose 0.3%, a lesser but still worrisome rate, since it was constrained by declines in prices of crude materials other than food and fuel, which are not likely to be repeated soon.

Although the producer price index (PPI) is more volatile than measures of consumer price inflation, it suggests that consumer price inflation could accelerate in the months ahead, as producers pass along, with a one- or two-quarter lag, these cost increases to their customers in the form of higher prices for finished goods and services. Recently released figures for personal income and outlays show a similar trend as May's jump in the price index used to deflate personal consumption expenditures (PCE) roughly matched the nominal increase in personal income, halting the strong gains in real disposable income in the first four months of this year.



How long these increases persist and how much, if at all, an increase in prices in one area can affect changes in prices in another are subjects of concern that could dampen both consumer and investor sentiment as the summer begins. Inflation expectations have also moved higher in the first half of 2004, and such a rise can, as a Fed governor recently warned, "become self-fulfilling as people seek to protect themselves in the process of setting wages and prices."[5]

The Fed, although somewhat surprised by the recent jump in inflation, continues to maintain that inflationary pressures are transitory and hence not likely to be a serious concern, and plans to respond at a "measured" pace with interest-rate increases, while warning that they may be wrong (as they appear to have been in 1994) and would move more aggressively to curb inflation should it accelerate further. Confused yet? Which is it?

One view is that the recent increases in the prices of oil, food and other items (such as clothes, cars and home furnishings) and coming increases in financing costs are transitory shocks that are unlikely to persist or translate into a long-term broader-based increase in consumer prices. This view looks for support in continued ample slack both in labor markets and productive capacity, and in the ability of producers to absorb higher labor costs that may result by trimming currently wide profit margins and through continued gains in productivity. Supporters of this view point to a full percentage-point increase in longer term market interest rates since mid-March in anticipation of the Fed's moves as evidence that the Fed is not "behind the curve."

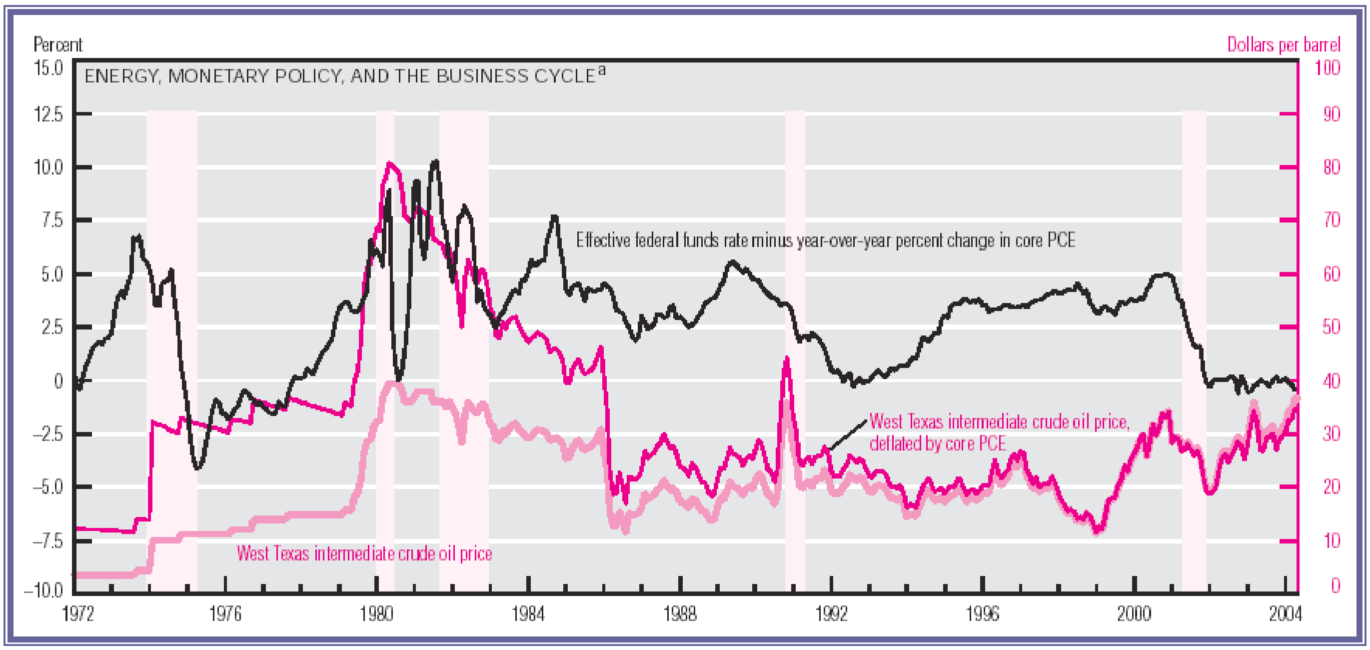
[5] Remarks by Federal Reserve Governor Donald L. Kohn, The Outlook for Inflation, National Economists Club, Washington, D.C., June 4, 2004.

In effect, this view sees the difficulties posed by recent price jumps as similar to, and no more distressing than, those problems confronting a python that swallows its prey, the proverbial pig, whole and is partially immobilized as it digests it. The pig moves through the python, creating a very unsubtle but gradually diminishing bulge as it does. Once digested, the pig leaves the python largely unchanged and the latter resumes normal motion.

The opposing view is that a series of price "shocks" that have arrived and are expected to arrive in the future are likely to be more persistent and resonate more deeply as they are transmitted, engendering a steadily rising rate of inflation for some time to come. Which view prevails depends largely on prospects for oil prices and interest rates, and the strength of the transmission of these "price shocks" through the economy via various channels.

The End of Cheap Money, The End of Cheap Oil

Some historical perspective on real oil prices and real interest rates might help in assessing these two opposing views. First, it is worthwhile noting that since World War II, oil prices have spiked and the real funds rate has risen before nearly every U.S. recession, including the most recent one. The real uncertainties with regard to both "shocks" are how persistent and how digestible they will prove to be.



Source: Reprint courtesy of the Federal Reserve Board of Cleveland, Economic Trends, June 2004.

The optimistic view expects oil prices to continue their recent retreat from record nominal highs of around $40 per barrel and that the economic impact of the recent "shock" is much less than in past jumps in oil prices. While nominal oil prices peaked in early 1980 at $40 per barrel, in real terms they were roughly twice as high as they are today. That is to say that expressed in 2004 dollars, oil prices in 1980 peaked at roughly $80 per barrel. In addition, the U.S. economy has become much less dependent on oil, and now uses half as much energy to produce a unit of GDP as it did 25 years ago. Optimists also point out that following a recent peak on June 1, oil prices retreated nearly 15% across the course of that month (as speculative positions were closed, supply disruptions in Norway and Iraq proved shorter than expected, and inventories were higher than previously believed) as evidence that the "shocks" will prove "transitory."

The pessimists expect rapidly rising oil demand to continue to outstrip supply, which in turn will increasingly be hobbled by disruptions in the Middle East and elsewhere. Global economic growth is expected to reach 5% in real terms this year, the fastest pace in two decades, and power even stronger growth in demand for oil, led by the growth of Chinese and U.S. oil consumption. Oil prices are expected to remain high if not move higher, which will be fully reflected, along with higher financing costs, in general wage and price increases. Add to that the perception of a lagging Fed response, and rising inflationary expectations are more likely to be fulfilled and become self-reinforcing. Pessimists question both the measures of spare capacity[6] and inflation used by policymakers, arguing that there is far less of the former and far more of the latter than indicated by official statistics, as occurred in 1994. Signs of slower productivity growth, the lagged impact of past dollar declines, and a return of "pricing power" in a number of industries are pointed to as evidence that a price spiral not unlike the one unleashed in the 1970s may have already begun.

The truth of course lies somewhere in between. As Lyle E. Gramley, a former Fed governor, recently said, "What's at issue here is whether the Fed is right. One can make a plausible case that inflationary pressures are not a concern, but it's awfully hard to make a compelling case."[7] When oil prices recently flirted with $40 per barrel, a level reached only once before in 1980, it invited some ill-advised comparisons to that earlier period. A more apt comparison is the period following the first oil price "shock" at end 1973 – early 1974, rather than following the second hike in late 1979 – early 1980.

The increase in oil prices that has occurred gradually over the past four years is comparable in magnitude and brought oil prices to the same real level as the increase that occurred more suddenly 30 years ago. The first OPEC-led hike stuck, persisting until the second, more profound shock arrived six years later. That added jump proved unsustainable and oil prices in real terms steadily declined over the next six years, before plunging in 1986.

Over the next 12 years, oil prices remained relatively stable, and a new price range centered just above $20 per barrel (in real terms), was interrupted by only one brief spike in prices during the first Gulf War, and one slump largely reflecting the impact of Asian and Russian financial crises in 1997-98. Over the next two years, oil prices moved sharply higher again, rising from roughly $12 per barrel to $34 per barrel before the last recession began. This short, shallow recession reversed only roughly half the earlier increases, and what had been the central tendency for oil prices during most of the 1990s, became an effective floor for a new trading range over the past four years. In the first half of this year oil prices jumped above that range, but appear to be establishing a new range around $32-$34 per barrel[8] as the second half opens. Despite greater

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[6] "(M)any economists reckon that (the Federal Reserve' s measure of capacity) currently overstates capacity because it fails to adjust for obsolete capital equipment and a faster pace of scrapping. Another measure, based on a survey of manufacturers by the Institute for Supply Management, suggests that firms are operating much closer to full capacity….Mismeasurement of the output gap was arguably to blame for the take-off in America's inflation in the 1970s….Official estimates of potential output at the time failed to spot that productivity growth had slowed,… so the amount of slack was grossly overstated …implying little reason to worry about inflation…with the benefit of hindsight and data revisions" it is now evident that little spare capacity existed, imply a significant buildup of inflationary pressures, that the Fed failed to foresee and respond to. *The Economist*, Global Inflation: A Ghost From the Past, June 19-25, 2004, p. 69.

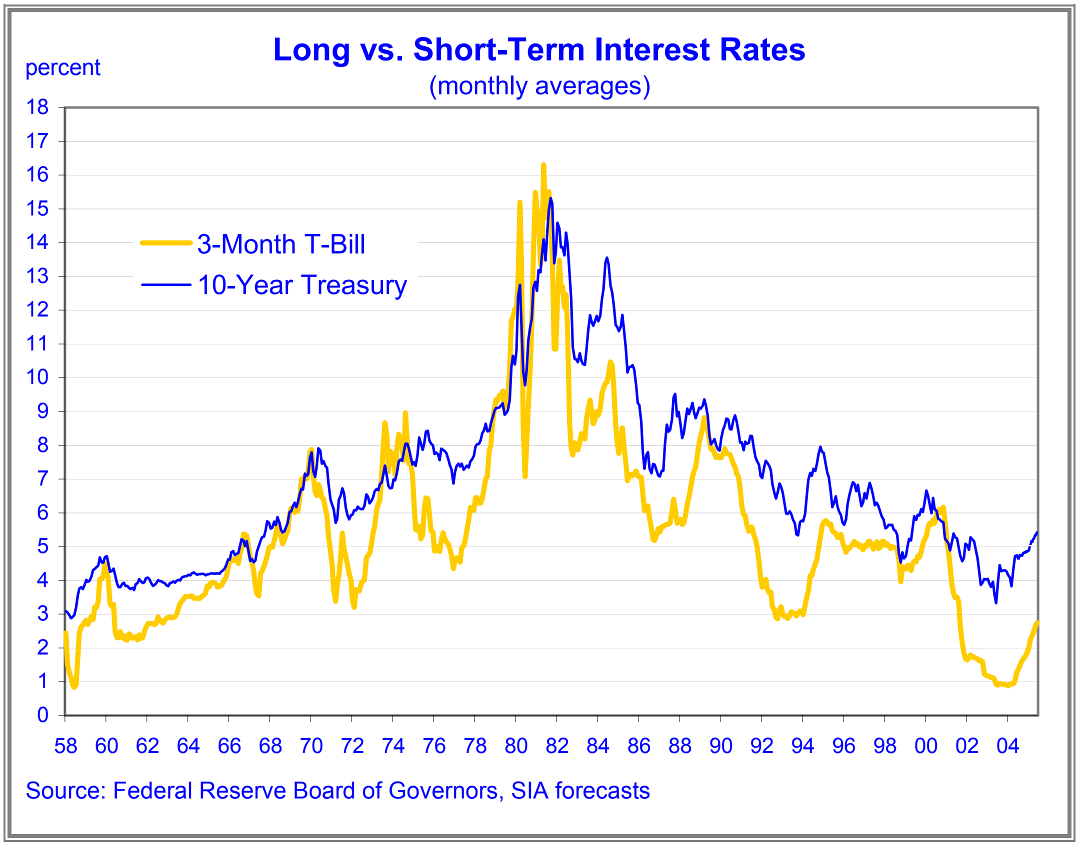
[7] Edmund L. Andrews, Economic View: A Fight Against Fear As Well as Inflation, *New York Times*, June 20, 2004.

[8] New York Mercantile Exchange near-month contract price.

supply expected later this year, prices are likely to stay in that range until exceptionally strong growth in global oil demand is curbed, which would entail overall growth to slow significantly.

So Long Sweet Spot

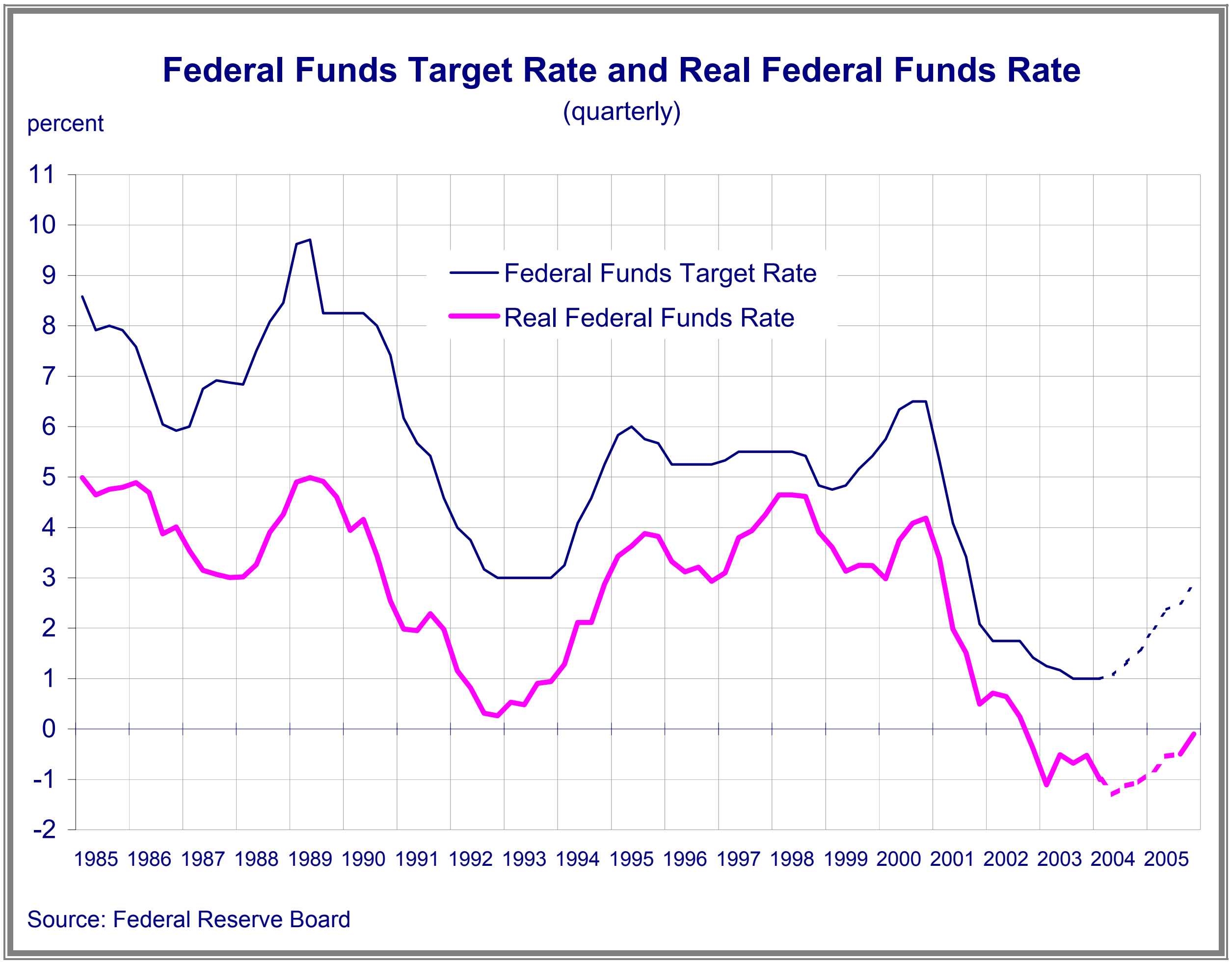
Expected interest-rate increases should do just that — slow overall growth — but they may well have appeared with too much delay and will likely be applied too gradually to prevent steadily higher inflation over the medium term, given the long lags required for monetary constraint to take effect (estimated at 1½ to 2 years). However, there is ample reason to believe that response times to this tightening cycle might be shorter than in past cycles.[9] First, the recent interest-rate hike may have been the most "telegraphed" in central bank history, and its impact was felt in advance of the actual move, with longer term market-determined rates rising a full percentage point in anticipation of this and expected increases.



Second, the economy may already be slowing. Economic growth has historically tended to accelerate in the first year of a tightening cycle, as the strong momentum that prompted Fed action carries the economy forward until the cumulative effect of a series of increases slows demand and output. In the current cycle, growth already appears to be slowing, in part due to the dissipation of the effects of massive fiscal stimulus that propelled growth over the past year. Third, household debt is at extremely high levels, and the 20 percent that is at variable rates is likely to more quickly raise already high debt-servicing ratios and constrain spending.

[9] David A. Rosenberg and Ron Wexler, The Market Economist, Hot Topic: The Macro Impact of Higher Interest Rates, Merrill Lynch, Global Securities Research and Economics Group, May 7, 2004, pp. 5-15.

In our last issue of *Research Reports*[10] we applied a principal guidepost for monetary policy to anticipate the pace and direction of interest-rate changes. What this indicated is that the federal funds rate should be somewhere between 2.5% and 3.5% today (depending on your choice of inflation "target"), rather than 1.25%, to prevent further acceleration in inflation. Although the Fed may indeed be "behind the curve," it is still expected to raise rates at only a "measured pace." However, one principal risk to the forecast is that half-point, rather than quarter-point, increases arrive unexpectedly.



In either event, the "sweet spot" in which the U.S. economy found itself in so recently, enjoying the rare combination of above-average economic and productivity growth, combined with historically low inflation and interest rates, already appears to be a thing of the past. That gilded age appears destined to be replaced by just the opposite: slowing growth in output and productivity accompanied by rising inflation and nominal interest rates. In addition, addressing the fundamental imbalances on household and government ledgers and external accounts that have emerged in recent years will constrain growth for some time to come.

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[10] SIA *Research Reports*, Vol. V, No. 6 (June 25, 2004).

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